Supreme Court, U. S.
FILED
MAY 10 1976
MICHAEL RODAK, JR., CLERK

No. 75-1381

In the Supreme Court of the United States

OCTOBER TERM, 1975

GERALD F. PADUANO, ET AL., PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

ROBERT H. BORK,
Solicitor General,
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The question in this federal income tax case is whether the court of appeals correctly upheld the Commissioner's allocation of income and deductions among a group of related taxpayers, pursuant to his authority under Section 482 of the Internal Revenue Code of 1954 (26 U.S.C.). That provision permits the Commissioner to allocate gross income, deductions, credits, or allowances among organizations, trades, or businesses owned or controlled by the same interests, if he determines that such allocation is necessary to prevent evasion of taxes or clearly to reflect the income of any of such organizations, trades, or businesses.

The pertinent facts are as follows: Gerald Paduano, Rocco Cappuccilli and Peter Cappuccilli[1] were equal partners in a firm that sold and rented real estate. Each partner also owned one third of the stock of three corporations—Stonehedge Development Corporation, Seneca Sewerage Corporation, and Cappy's Real Estate, Inc. (Pet. App. A 6).

During 1962, the partnership advanced $1,075,000 to Stonehedge in an interest-free mortgage loan. The partnership also loaned an additional $106,000 to Stonehedge and Seneca in mortgage loans at six percent interest, but no interest was paid on these loans. However, Stonehedge and Seneca in mortgage loans at six-percent during this period. Finally, the partnership advanced additional funds to Stonehedge and Cappy's to enable them to continue in operation, but interest was neither charged nor paid on these advances (Pet. App. A 7-A 8; Pet. 3).

Pursuant to his authority under Section 482, the Commissioner allocated interest income to the partnership at the rate of five percent per annum on these loans. Correlative interest deductions were allowed to Stonehedge, Seneca, and Cappy's (Pet. App. A 10). Deficiencies were thereby determined against each partner on his distributive share of the additional partnership interest income. The Tax Court sustained the Commissioner's allocation (Pet. App. A 9-A 12), and the court of appeals affirmed by order (Pet. App. A 12-A 13).

It is well established that when one member of a commonly controlled group of taxpayers advances funds to

[1]Caroline Paduano, Dorothy Cappuccilli, and Grace Cappuccilli were parties to this action only because they filed joint income tax returns with their husbands.

another member, but fails to charge an arm's-length rate of interest, the Commissioner may allocate interest to the creditor under Section 482, without regard to accrual accounting principles.[2] See, *e.g.*, *B. Forman Co.* v. *Commissioner*, 453 F.2d 1144, 1156 (C.A. 2), certiorari denied, 407 U.S. 934; *Kahler Corp.* v. *Commissioner*, 486 F.2d 1, 4-5 (C.A. 8); *Kerry Investment Co.* v. *Commissioner*, 500 F.2d 108, 109 (C.A. 9); *Fitzgerald Motor Co.* v. *Commissioner*, 508 F.2d 1096, 1100-1101 (C.A. 5). For if the Commissioner could not allocate interest income in such circumstances, interest-free loans could be used by a controlled group as a means of shifting income from its profitable members to those which have experienced losses, thereby reducing the total tax liability of the group. Thus, the allocation of income in this case is in accord with this Court's observation that "§ 482 is designed to prevent 'artificial shifting, milking, or distorting of the true net incomes of commonly controlled enterprises.'" *Commissioner* v. *First Security Bank of Utah*, 405 U.S. 394, 400.[3]

Petitioners acknowledge (Pet. 6) that the courts of appeals have consistently upheld the Commissioner's authority under Section 482 to allocate interest income in these circumstances. But they argue that the aliocation was improper on the facts of this case because the debtor corporations had experienced financial difficulties so that their payment of interest could not reasonably be expected. The record indicates, however, that at least two of the three

[2]Thus, the accrual accounting cases relied upon by petitioner (Pet. 14-15) are not pertinent authority.

[3]The rejection of the Commissioner's Section 482 allocation in *Commissioner* v. *First Security Bank of Utah, supra*, and in *L. E. Shunk Latex Products, Inc.* v. *Commissioner*, 18 T.C. 940, arose in distinguishable situations (see Pet. 17, 20). In both of those cases, the taxpayers were legally prohibited from receiving the income allocated to them.

corporations (Stonehedge and Seneca) paid interest to other third-party creditors during the period in question. Thus, there is no factual support for petitioners' hypothesis that their debtor corporations could not have paid interest to the partnership.

At all events, there is no legal basis to petitioners' argument. If the financial inability of a member of a controlled group to pay interest could defeat the Commissioner's Section 482 allocation, it would be a relatively simple matter to arrange such inability in advance of an interest-free loan. The objective standard of Section 482 requires the allocation of interest income when interest-free loans are made among members of a controlled group.[4]

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

ROBERT H. BORK,
Solicitor General.

MAY 1976.

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[4]Although petitioners (Pet. 15) point to a concession made by the Commissioner in *Pitchford's, Inc.* v. *Commissioner*, 34 T.C.M. 384, that interest would not be allocated where the debtor was in poor financial condition, that concession was improvident. As we pointed out in our brief in the court of appeals in this case (pp. 15-16), that concession does not represent the views of the Commissioner, and does not bind the Commissioner in any other case.